[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND FRANCE

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON AUGUST 9, 1988

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on ιxation, describes the proposed supplementary protocol to the .come tax treaty between the United States and France. The pro- ›sed protocol was signed on June 16, 1988, and was amplified by ι exchange of notes signed the same day. The proposed protocol ould amend the current U.S.-France income tax treaty, which en- ›red into force on July 11, 1968, as amended by the protocols of ctober 12, 1970, November 24, 1978, and January 17, 1984 ("the κisting treaty"). A public hearing on the proposed protocol is :heduled on August 9, 1988, by the Senate Committee on Foreign elations.

The primary reason for the negotiation of the proposed protocol 'as to implement the many U.S. tax policy changes enacted in the ax Reform Act of 1986 (the "1986 Act") as they affect existing [.S. income tax treaties. For example, the 1986 Act enacted a ranch profits tax to be imposed generally on the U.S. business ıcome of a foreign corporation doing business in the United tates. Although the existing treaty provides for a branch profits ıx, the proposed protocol updates the existing treaty to account ›r the tax actually imposed by the 1986 Act.

In addition to updating the U.S.-France income tax treaty for the 986 Act's policy changes, the proposed protocol adds a new exemp- ion from French income tax for certain types of U.S.-related in- estment income of French residents who are U.S. citizens.

The first part of the pamphlet is a summary of the principal pro- isions of the proposed protocol. The second part presents a discus- ion of the issues raised by the proposed protocol. This is followed ıy a third part containing a detailed, article-by-article explanation f the proposed protocol.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Pro- ›osed Protocol to the Income Tax Treaty between the United States and France* (JCS-14-88), \ugust 8, 1988.

I. SUMMARY

The proposed protocol contains the following modifications to t
income tax treaty between the United States and France.

(1) Definition of resident.—The proposed protocol would a
France and its local authorities, and the United States and its
litical subdivisions or local authorities, to the definitions of Fren
resident and U.S. resident, respectively. The provision would imp
ment the intent of a provision of the 1986 Act to treat a forei
government as a resident of its country for treaty purposes so lo
as it extends reciprocal treatment to the United States.

(2) Definition of business profits.—The proposed protocol wou
amend the definition of business profits contained in the existi
treaty to clarify that the business profits attributable to a perm
nent establishment that a resident company has in the other cou
try would include any such gain or income where the payments f
such gain or income are not received until after the permanent
tablishment has ceased to exist. This provision would implement
provision of the 1986 Act that treats any gain or income of a f
eign person for any taxable year which is attributable to a transa
tion in any other taxable year as effectively connected with t
conduct of a U.S. trade or business if it would have been so treat
had it been taken into account in the other taxable year.

(3) Dividends.—The proposed protocol would amend the existi
treaty to preclude the United States from imposing its divide
withholding tax on dividends paid by French resident corporatio
which have a certain amount of income attributable to a U.S. pe
manent establishment. This modification is consistent with t
United States imposing a branch profits tax on the U.S. permane
establishment of the French resident. The proposed protocol al
would update the definition of dividends to conform with defi
tions in the 1981 proposed U.S. model income tax treaty ("U.
model treaty") and the model income tax treaty of the Organiz
tion for Economic Cooperation and Development ("OECD mod
treaty").

(4) Interest.—The proposed protocol would add to the treaty
rule allowing a treaty country to impose an otherwise allowab
withholding tax on interest paid or accrued by a permanent esta
lishment or fixed base in that country as soon as the permane
establishment or fixed base accrues a deduction for the interest.

(5) Royalties.—The proposed protocol provides a new sourcin
rule for royalties, clarifies the treatment of royalties beneficial
owned by a resident of the United States or France, and adds
rule allowing a treaty country to impose an otherwise allowab
withholding tax on a royalty paid or accrued by a permanent esta
lishment or fixed base in that country as soon as the permane
establishment or fixed base accrues a deduction for the royalty.

'6) *Capital gains.*—Like the amendment to the definition of busiss profits described above, the proposed protocol would amend e existing treaty to clarify that a country may tax capital gains tributable to a permanent establishment in that country even if e payments on the gains are received after the permanent estabhment has ceased to exist.

(7) *Branch profits tax.*—The proposed protocol would allow the nited States to impose its branch profits tax on the business prof- attributable to a U.S. permanent establishment that a French sident has in the United States, and would limit both the U.S. d French branch profits taxes rates on residents of the other untry to 5 percent.

(8) *Relief from double taxation.*—The proposed protocol adds a w exemption from French income tax for certain types of U.S.-lated investment income of French residents who are U.S. citins so long as those French residents have demonstrated that they ve complied with their U.S. tax obligations. The proposed protol also requires France to give a tax credit for U.S. branch profits x paid by French residents.

(9) *Anti-treaty shopping provision.*—Consistent with certain prosions of the 1986 Act, the proposed protocol strengthens the existg treaty's anti-treaty shopping provision by adding a "base eroon" rule that prevents a resident receiving benefits from the her country from reducing the income base that is subject to tax the residence country.

II. ISSUES

The treaty as it would be modified by the proposed proto
raises the following specific issues:

(1) Dividends paid by pass-through entities

Under the existing treaty, the maximum allowable rate of tax source on dividends is 15 percent, or 5 percent in certain ca where the recipient is a corporation that is a "direct" investor; th is, one that (as of the day before the dividend is paid) owned least 10 percent of the payor's voting stock during the payor's c rent and prior taxable years. The reduction in rate to 5 percent not available where the payor received more than 25 percent of prior year gross income from certain interest and dividends (oth than interest derived in the conduct of a banking, insurance, or nancing business and dividends or interest received from 50-p cent or more owned subsidiaries).

These reductions from the Internal Revenue Code withholdi rate of 30 percent are consistent with the U.S. model treaty. Th reflect the view that where, for example, the United States alrea imposes corporate level tax on the earnings of a U.S. corporation 30-percent withholding rate may represent an excessive level source country taxation. Moreover, the 5 percent rate reflects t view that the source country tax on payments of profits to a su stantial foreign corporate shareholder may properly be reduc further to avoid double corporate-level taxation and to facilita international investment. However, there is a concern that the reductions may be inappropriate where the United States is t source country and it imposes little or no corporate-level tax on t payor of the dividend.

A real estate investment trust (REIT) is a corporation, trust, association that is subject to the regular corporate income tax, b that receives a deduction for dividends paid to its shareholders certain conditions are met. (Code sec. 857(b).) One of those con tions is the requirement that a REIT distribute most of its incon Thus, a REIT is treated, in essence, as a conduit for federal incor tax purposes. A REIT is organized to allow persons to diversify ow ership in primarily passive real estate investments. Often, the pr cipal income of a REIT is rentals from real estate holdings.

Because a REIT is taxable as a U.S. corporation, a distribution earnings is treated as a dividend, rather than income of the sa type as the underlying earnings. This is true even though the RE generally is not taxable at the entity level on the earnings it d tributes. Because a REIT cannot be engaged in an active trade business, its distributions are U.S. source and are thus subject U.S. withholding tax of 30 percent when paid to foreign owne Distributions of rental income, for example, are not themselv considered rental income. Like dividends, U.S. source rent

ome of foreign persons is generally subject to U.S. withholding at a statutory rate of 30 percent (unless, in the case of rental ome, the recipient elects to have it taxed in the United States a net basis at the regular income tax rates). Unlike the tax on idends, however, the withholding tax on rental income is gener- not reduced in U.S. income tax treaties.

t has always been the United States position to preserve the ht to tax income from real property to the country in which the ome is derived. Thus, the United States always preserves its ht to tax real property income derived from the United States in income tax treaties.

The Internal Revenue Code also generally treats regulated in- tment companies (RICs) as both corporations and conduits for ome tax purposes. The purpose of a RIC is to allow investors to d a diversified portfolio of securities. For this reason, the par- ular rationale for the 5 percent treaty withholding rate would erally make it inappropriate to apply that rate to the withhold- tax on RIC dividends, regardless of the proportion of the RIC's ck owned by the dividend recipient.

n general, the existing treaty would not appear to allow the 5- rcent rate on dividends from a RIC because typically more than percent of a RIC's income is interest and dividends not from any nking, insurance, or financing business and not from any 50-per- nt or more owned subsidiaries. On the other hand, it may be pos- le for a RIC to fall below this threshold by investing heavily in n-income-producing securities or other assets.

The issue presented by the application of the existing treaty to ITs and RICs is whether dividends paid by a REIT or a RIC ould be treated differently from dividends paid by other U.S. cor- rations. Because REITs generally do not pay any corporate level S. income tax, and because a REIT's income often is composed of type of income over which the United States maintains its right tax in its treaties, reducing the U.S. withholding tax rate on IT dividends as under the existing treaty is inconsistent with purposes of dividend rate treaty reductions. Similarly, because Cs generally do not pay any corporate level U.S. income tax, and cause, on a conduit theory, RIC investors are generally "portfo- " investors in the underlying RIC assets, it may be inappropriate allow taxation of RIC dividends at the "direct" investor with- lding rate in those instances (presumably rare) where a RIC's in- rest and dividend income is below the treaty's 25-percent thresh- l. Even if it were appropriate to reduce source country taxation income derived through entities such as REITs and RICs, it may inappropriate for the United States to do so, in effect, unilater- y. The proposed protocol does not address either concern.

The committee could consider a reservation to the proposed pro- col to require a further modification to the treaty's dividend arti- that would address these concerns. The proposed protocol does t purport to address the dividend withholding rate issue, howev- . It is understood, moreover, that the Treasury Department con- lers the application of a 5-percent rate to REIT and RIC divi- nds to be inapprorpiate. It is further understood that the Treas- y Department is willing to initiate negotiations to conform the isting treaty with that view. Because a reservation would consider-

ably delay the benefits to be derived by U.S. citizens under the p posed protocol, the committee could consider the proposed proto on the understanding that negotiations will be undertaken exp tiously to modify the dividend reductions contained in the exist treaty.

(2) Treaty shoppings

The proposed protocol, and the existing treaty, like a numbe U.S. income tax treaties, both generally limit treaty benefits treaty country residents other than individuals so that only th residents with a sufficient nexus to a treaty country will rece treaty benefits. Although the proposed protocol is intended to be fit residents of France and the United States only, residents third countries sometimes attempt to use a treaty to obtain tre benefits. This is known as treaty shopping. Investors from co tries that do not have tax treaties with the United States, or fr countries that have not agreed to their tax treaties with the Uni States to limit source country taxation to the same extent that i limited in another treaty may, for example, attempt to secur lower rate of U.S. tax by lending money, for example, to a U person indirectly through a country whose treaty with the Uni States provides for a lower rate. The third-country investor may this by establishing a subsidiary, trust, or other investing entity that treaty country which then makes the loan to the U.S. pers and claims the treaty reduction for the interest it receives.

Aspects of the anti-treaty shopping provision of the proposed p tocol and of the existing treaty differ either from the anti-tre shopping provision of the U.S. model or from the anti-treaty sh ping provisions sought by the United States in some treaty negot tions since the model was published in 1981. The issue is wheth the anti-treaty shopping provision of the treaty as modified by t proposed protocol effectively forestalls potential treaty shoppi abuses.

One provision of the anti-treaty shopping article of the propos protocol is more lenient than the comparable rule in the U model and other U.S. treaties. The U.S. model allows benefits to denied if 75 percent or less of a resident company's stock is held individual residents of the country of residence, while the propos protocol (like several newer treaties and an anti-treaty shoppi provision in the Internal Revenue Code) lowers the qualifying p centage to 50, and broadens the class of qualifying shareholders include residents of either treaty country (and citizens of t United States). Thus, this safe harbor is considerably easier enter, under the proposed protocol. On the other hand, counting f this purpose shareholders who are residents of either treaty cou try would not appear to invite the type of abuse at which the pro sion is aimed, since the targeted abuse is ownership by third-cou try residents attempting to obtain treaty benefits.

Another provision of the anti-treaty shopping article conforms the comparable rule of the U.S. model, but not the comparable ru in treaties negotiated more recently. The general test applied the U.S. model to deny benefits is a broad one, looking to wheth the acquisitions, maintenance, or operation of an entity had "as principal purpose obtaining benefits under" the treaty. By contras

Treasury has more recently sought in negotiations a more pre- test that allows denial of benefits only with respect to income derived in connection with the active conduct of a trade or iness.

'he practical difference between the two tests will depend upon v they are interpreted and applied. The principal purpose test y be applied leniently (so that any colorable business purpose fices to preserve treaty benefits), or it may be applied strictly (so t any significant intent to obtain treaty benefits suffices to deny m). Similarly, the trade or business test could be interpreted to uire a more active or a less active trade or business (though the ige of interpretation is far narrower). Thus, a narrow reading of active business test could be stricter than a broad reading of principal purpose test (i.e., would operate to deny benefits in entially abusive situations more often).

Moreover, the IRS may find it relatively difficult to sustain a rrow reading of the principal purpose test. (In litigation involv- Code section 367, for example, which utilized a principal pur- se test until 1985, courts have consistently refused to apply this t to transactions where taxpayers could claim any business pur- se.) Given that possibility, it may well be that the test contained the existing treaty and the proposed protocol will prove less ict than the active business test.

The committee could consider a reservation to the proposed pro- col to require a modification to the limitation on benefits article at would replace the principal purpose test with the active busi- ss test. As in the case of dividend withholding on REITs and Cs, however, the proposed protocol does not purport to address is issue. Moreover, the differences between the two tests are in me cases not clear-cut, and in any case the Treasury Department s recently shown a preference for adoption of the active business st in treaty negotiations. Because a reservation would consider- ly delay the benefits to be derived by U.S. citizens under the pro- sed protocol, the committee could consider the proposed protocol the understanding that in negotiations undertaken in the future e Treasury will seek to modify the principal purpose test.

III. EXPLANATION OF PROPOSED PROTOCOL

A detailed, article-by-article explanation of the proposed proto to the income tax treaty between the United States and France presented below.

Article I. Taxes Covered

The proposed protocol would amend the existing treaty to clar that the U.S. income taxes covered by the treaty are those of t Internal Revenue Code of 1986.

Article II. Definition of Resident

The proposed protocol would add France and its local authoriti and the United States and its political subdivisions or local a thorities, to the definitions of French resident and U.S. resident, spectively. Thus, the proposed protocol renders income derived any of these entities from sources within the other country eligi for treaty benefits. This provision implements a statement in t legislative history of section 892 of the Internal Revenue Code ("t Code") as amended by the 1986 Act, that for treaty purposes, a f eign government is intended to be treated as a resident of its cou try, unless it denies treaty benefits to the United States. (*See* S Rep. No. 313, 99th Cong., 2d Sess. 418 (1986).)

Article III. Business Profits

Under the business profits article of the existing treaty, indust al or commercial profits of a resident of one treaty country are ta able only in that country unless the resident is engaged in indust al or commercial activity in the other country through a perm nent establishment situated in that other country. If the resident so engaged, the other country may tax only so much of the re dent's profits as are attr:ibutable to the permanent establishme The profits attributed to the permanent establishment are tho which would be attributable to it if the permanent establishmen were an independent entity engaged in the same or similar acti ties under the same or similar conditions and dealing at arm length with the resident of which it is a permanent establishmen

The 1986 Act provided that any income or gain of a forei person for any taxable year which is attributable to a transacti in any other taxable year will be treated as effectively connect with the conduct of a U.S. trade or business if it would have be so treated had it been taken into account in that other taxab year (Code sec. 864(c)(6)). In addition, the 1986 Act provided that any property ceases to be used or held for use in connection wi the conduct of a trade or business within the United States, the d termination of whether any income or gain attributable to a sale exchange of that property occurring within 10 years after the ce sation of business is effectively connected with the conduct of tra

ɔusiness within the United States shall be made as if the sale or hange occurred immediately before the cessation of business de sec. 864(c)(7)).

Consistent with the first of these 1986 Act changes, the proposed tocol would amend the business profits article of the existing aty to clarify that, for purposes of the treaty rules stated above, income or gain attributable to a permanent establishment that reaty country resident has in the other country is taxable in it other country even if the payments are deferred until after permanent establishment has ceased to exist. The proposed pro- ol would similarly amend the capital gains article to clarify that hing therein prevents the country in which the permanent es- lishment is located from taxing the gain permitted to be taxed der the business profits article as it would be amended by the posed protocol. It is understood that no change to the existing aty is believed necessary to conform the treatment of income de- ed from independent personal services with Code section 4(c)(6) as added by the 1986 Act. (See discussion of Article VII of proposed protocol below.) The proposed protocol does not, how- er, amend the existing treaty to conform to the rule in Code sec- n 864(c)(7).

The proposed protocol would also insert language into the busi- ss profits article to the effect that when an insurance company one of the countries has a permanent establishment in the other untry, reinsurance premiums received shall be taken into ac- unt for the determination of taxable profits only in the country which the company is a resident.

The tax treatment of investment income attributable to premi- ns covered by the provision is the subject to a Revenue Ruling ev. Rul. 77–62, 1977–1 C.B. 414) issued after consultation between e competent authorities of the United States and France. The ling states that the term "reinsurance premiums" used in the 67 note shall be viewed as including investment income derived connection with the conduct of a reinsurance business in one of e contracting states by an insurance company that is a resident the other contracting state. The Technical Explanation to the oposed protocol states that no inference should be drawn from e proposed protocol's reinsurance provision with respect to the x treatment of the investment income described above.

rticle IV. Dividends

Subject to special rules for permanent establishments and fixed ises, the existing treaty generally prohibits taxation by a treaty untry of dividend income derived by a resident of the other coun- y from sources outside the first country. Thus, for example, gen- ally a dividend paid by a French corporation to a French resident not taxable by the United States (unless the resident is a U.S. tizen). Prior to the 1986 Act, the Internal Revenue Code treated U.S. source income, and imposed a withholding tax on a portion , dividends paid by a foreign corporation to foreign shareholders the U.S. effectively connected gross income of the corporation ex- eeded a 50 percent threshold over a 3-year period (former Code c. 861(a)(2)(B)). The 1986 Act amended this source rule and pro- ibited imposition of this tax in the case of any dividends paid by a

foreign corporation in a year for which it is not exempt from t Code's branch profits tax.

The existing treaty allows a subclass of the dividends describ above to be treated as U.S. source dividend income of French re dents. In order for dividends to be treated as U.S. source under t treaty, the corporation must have a U.S. permanent establishme and more than 80 percent of the corporation's gross income for a year period prior to the year in which the dividend was declar must have been taxable to the permanent establishment. After t 1986 Act, a foreign corporation is generally subject to the bran profits tax on its U.S. trade or business. Moreover, a French cor ration would generally be subject to branch profits tax under t proposed protocol (see discussion of Article VIII below) on any di dend equivalent amount attributable to the permanent establis ment for the year in which the dividend was declared. Conseque ly, under the 1986 Act and Article VIII of the proposed protoc such a corporation would not be subject to U.S. withholding tax dividends it pays, even if dividends of that corporation were treat as U.S. source dividends under the existing treaty rule describ above.

Consistent with this 1986 Act change, the proposed proto would delete from the treaty the rule treating as U.S. source di dends those dividends paid by French corporations with 80 perce of their gross income taxable to a U.S. permanent establishme during the prior 3-year period.

The proposed protocol would also add to the treaty, at Franc request, a definition of "dividend" for purposes of the treaty's di dend article (Article 9 of the treaty). The definition is largely ide tical to the definition in the OECD model treaty. Like the U model treaty, the proposed protocol defines "dividends" as incor from shares or other rights which participate in profits and whi are not debt claims. To conform with French law, the term also i cludes income from "jouissance" shares or "jouissance" righ mining shares, or founders shares which participate in profits a which are not debt claims. Dividends also include income fro other corporate rights which is subjected to the same tax treatme by the country in which the distributing corporation is resident income from shares. Under this provision, each country may app its rules for determining when a payment by a resident company on a debt obligation or an equity interest.

Article V. Interest

The existing treaty provides that when a person paying intere has a permanent establishment or fixed base in a treaty countr in connection with which the indebtedness giving rise to such inte est was incurred, and such interest is borne by such permanent e tablishment or fixed base, then the interest shall be deemed arise in the country in which the permanent establishment or fixe base is situated. The proposed protocol would add that the intere shall be deemed to be paid by the permanent establishment fixed base to the beneficial owner at the latest when it is take into account as an expense of the permanent establishment fixed base. Thus, for example, where a U.S. resident has a perm nent establishment in France that accrues interest it owes to

rd country resident, and that interest would be French source ome of the third country resident subject to French withholding :, the proposed protocol would allow France to impose a liability the U.S. resident for the withholding tax as of the date that the ·manent establishment accrues the interest as a deduction for rposes of computing its own French income tax liability.

\ccording to the Technical Explanation, this provision is not to construed as requiring the beneficial owner of the interest to y tax to the source country prior to the actual payment of the erest, in circumstances where the payor has failed to remit the : to that country until after the payor takes the payment into count as an expense. Thus, in the example given above, if the rmanent establishment has accrued its interest deduction for ench tax purposes without paying the interest to the third coun- resident and without paying the withholding tax to France, en until the interest payment is actually made to the third coun- resident, nothing in the proposed protocol is to be construed as posing liability for the withholding tax on the third country resi- nt.

ticle VI. Royalties

The proposed protocol provides a new sourcing rule for royalties, arifies the treatment of royalties beneficially owned by a resident the United States or France, and provides a rule governing the test time when royalties shall be deemed paid.

Source rules

Under the existing treaty, royalties paid for the use of in one of e treaty countries, or for the right to use in that country, pat- its, designs or models, plans, secret processes or formulae, trade- arks, or other like property or rights, or for know-how, are treat- l as income from sources within that country. The proposed proto- l would replace this source rule with a three part test. As under e treaty, the protocol would provide that in all cases royalties aid for the use of or the right to use property in the United States all be deemed to arise in the United States. However, the pro- osed protocol would generally source all other royalties by refer- nce to the residence of the payor or to the location of any perma- ent establishment or fixed base of the payor that bears the royal- and to which the liability to pay the royalty is attributable.

Thus, unless the royalty is for the use of or the right to use prop- rty in the United States, royalties would be deemed to arise in a eaty country when the payor is that country itself, a local author- y, a statutory body, or a resident of that country. Where, howev- r, the payor of such a royalty (whether or not a treaty country esident) has a permanent establishment or fixed base in a treaty ountry, the liability to pay the royalty is incurred in connection ith that permanent establishment or fixed base, and the royalty borne by that permanent establishment or fixed base, then the oyalties would be deemed to arise in the country where the per- nanent establishment or fixed base is situated.

According to the Technical Explanation, this change would prac- ically relate only to French tax. Under both the existing treaty nd the proposed protocol, French residents generally pay U.S. tax

on royalties they receive only when the royalties are derived fro U.S. sources or the right or property giving rise to the royalties effectively connected with a permanent establishment of t French resident in the United States. All royalties received by French resident that would be sourced in the United States by t existing treaty would also be sourced in the U.S. by the propos protocol. Theoretically, the proposed protocol would slightly expa the category of U.S. source royalties to include royalties paid by U.S. resident (or a U.S. permanent establishment) for the use of i tangible property outside the United States. Thus under the prot col the United States could potentially extend its taxing jurisdi tion over royalties paid to French residents. However, since t Code generally does not permit U.S. gross basis tax on such roya ties earned by foreign persons (because they are not derived fro U.S. sources), no practical effect on U.S. tax liabilities of such pe sons would result from this change.

On the other hand, the proposed protocol would change t taxing jurisdiction of France over royalty income of U.S. residen in order to conform the jurisdiction permitted by the treaty wi the source rules of internal French law. Under the existing treat if the right or property giving rise to such income is not effective connected with a permanent establishment of the U.S. resident France, then generally such income is taxable by France only if is for the use of intangible property in France. Under the propos protocol, if such royalties are paid to the U.S. resident by a Belgia resident without a French permanent establishment, even for u of the intangible in France, then no French tax would be impose By contrast, if the Belgian resident does have a French permane establishment, and the liability to pay the royalties was incurr by that permanent establishment and the royalty was borne l that permanent establishment, then the proposed protocol wou allow France to tax the royalty regardless of whether it was for t use of intangible property in France.

Beneficial owners

The existing treaty limits or prevents source country taxation c certain royalties derived by residents of the treaty countries in ce tain circumstances. According to the Technical Explanation, it wa believed that this language could be interpreted to deny treaty be efits to treaty country residents that beneficially owned royalti derived from sources in the other country, but who received th income through a nominee. In order to clarify that this is not th case, the proposed protocol would amend the treaty so that would limit (or prevent) source country taxation only in case where the *beneficial owner* of the royalties is a resident of th other treaty country. Thus, the treaty as amended would provid that where royalties are earned by a beneficial owner who is a res dent of one of the treaty countries and the royalties arise in th other country, they may be taxed by the other country at a rat not exceeding 5 percent of the gross amount paid. Similarly, th amended treaty would provide that the source country will not ta royalties derived from copyrights of literary, artistic, or scientifi work by a beneficial owner who is a resident of the other countr

Time royalties deemed paid

[T]he proposed protocol would provide that royalties are deemed [pai]d to the beneficial owner at the latest when they are taken into [acc]ount as expenses. (See discussion of Article V above for a discus[sio]n of the parallel rule for interest.) Again according to the Tech[nic]al Explanation, this rule is not to be construed as requiring one [to] whom a royalty is owed to pay withholding tax to a treaty coun[try], prior to the time that the royalty is actually paid, in a case [wh]ere the payor takes the royalty expense into account as an ex[pe]nse before the payor remits withholding tax to that country.

[Ar]ticle VII. Capital Gains

[U]nder the capital gains article of the existing treaty, generally a [res]ident of France or the United States is not taxable by the other [cou]ntry on gains from the sale or exchange of capital assets. One [ex]ception to this rule allows taxation by one country of gain of a [res]ident of the other country that is effectively connected with that [res]ident's permanent establishment in the first country. Another [ex]ception allows taxation by one country of gain of an individual [res]ident of the other country that is effectively connected to that [in]dividual's fixed base in the first country.

[T]he 1986 Act provided that any income or gain of a foreign [pe]rson for any taxable year which is attributable to a transaction [in] any other taxable year will be treated as effectively connected [wi]th the conduct of a U.S. trade or business if it would have been [so] treated had it been taken into account in that other taxable [ye]ar (Code sec. 864(c)(6)). In addition, the Act provided that if any [pr]operty ceases to be used or held for use in connection with the [co]nduct of a trade or business within the United States, the deter[mi]nation whether any income or gain attributable to a sale or ex[ch]ange of that property occurring within 10 years after the cessa[tio]n of business is effectively connected with the conduct of trade [or] business within the United States shall be made as if the sale or [ex]change occurred immediately before the cessation of business [(C]ode sec. 864(c)(7)).

Consistent with the first of these 1986 Act changes, the proposed [pr]otocol would amend the business profits article of the existing [tr]eaty to clarify that any income or gain attributable to a perma[ne]nt establishment of a treaty country resident is taxable in that [co]untry even if the payments are deferred until after the perma[ne]nt establishment has ceased to exist. (See discussion of Article III [ab]ove.) The proposed protocol would similarly amend the capital [ga]ins article to clarify that nothing therein prevents the country in [wh]ich the permanent establishment is located from taxing the gain [pe]rmitted to be taxed under the business profits article as it would [be] amended. As an example of this provision, the Technical Expla[na]tion states that installment payments received from the sale of [eq]uipment used by a U.S. permanent establishment of a French [co]rporation after the permanent establishment has ceased to exist [ar]e "treated under Article 6 (Business Profits) of the Convention."

It is understood that no change to the capital gains article is be[li]eved necessary to conform the treatment of gain effectively con-

nected to a fixed base in a treaty country with Code secti 864(c)(6) as added by the 1986 Act.

The proposed protocol does not conform the treaty's treatment capital gains to Code section 864(c)(7) as added by the 1986 Act.

Article VIII. Branch Profits

The proposed protocol would make a number of changes to t existing treaty related to provisions of the 1986 Act enacting the percent branch profits tax (Code sec. 884(a)). The protocol wou provide for a maximum 5 percent rate on both the U.S. and Fren branch profits taxes as applied to corporations of the other count eligible for treaty benefits and would expand the current treat exemption from the U.S. accumulated earnings tax for certa French corporations, in order to cover those corporations th would be subject to the U.S. branch tax under the proposed pro col.

Branch profits tax

The 1986 Act imposed branch level taxes on foreign corporatio earning income effectively connected with the conduct of a U trade or business. The Act provided that no U.S. treaty sh exempt any foreign corporation from the branch profits tax reduce the amount thereof) unless the foreign corporation is "qualified resident" of the treaty country or the treaty satisfies c tain other criteria. (A bill passed by the House of Representati and pending in the Senate which includes technical corrections the 1986 Act amends this requirement to provide that only qua fied treaty country residents are entitled to treaty waivers or ductions of the branch profits tax.)

The Act defines a "qualified resident" as any foreign corporati which is a resident of a treaty country if can meet at least one the following tests. First, any foreign corporation resident in treaty country will be a qualified resident of that country unle more than 50 percent (by value) of the stock of the corporation owned (directly or indirectly within the meaning of Code secti 883(c)(4)) by individuals who are not residents of the treaty count and who are not U.S. citizens or resident aliens,[2] or 50 percent more of its income is used (directly or indirectly) to meet liabiliti to persons who are not residents of the treaty country or t United States. Second, a foreign corporation resident in a trea country is a qualified resident if the stock of the corporation is p marily and regularly traded on an established securities market the treaty country, or if the corporation is wholly owned (either rectly or indirectly) by another foreign corporation which is org nized in the treaty country and the stock of which is so trade Third, the corporation may receive qualified resident status if it tablishes to the satisfaction of the Secretary that it meets such quirements as the Secretary may establish to ensure that indiv

[2] The pending technical corrections bill referred to above would amend this requiremen that it would disqualify a corporation owned *50 percent or more* by individuals who are not dents of the treaty country and who are not U.S. citizens or resident aliens.

[3] The pending technical corrections bill would amend this requirement so that a foreign poration would also be a qualified resident if wholly owned by a U.S. corporation whose stoc primarily and regularly traded on an established securities market in the United States.

s who are not residents of the treaty country do not use the aty in a manner inconsistent with the purposes of the treaty es contained in the Code provisions regarding the branch profits :.

[he proposed protocol would allow the United States to impose : branch profits tax (as opposed to the branch level interest tax ›de sec. 884(f)) on a French corporation that has a permanent es- ›lishment in the United States and would allow France to pose its branch profits tax on a United States corporation that s a permanent establishment in France. However, the proposed ›tocol would allow a reduction in the branch tax rate imposed by : Code on French corporations and, in cases where a foreign cor- ration conducts a trade or business in the United States but not :ough a permanent establishment, the proposed protocol would npletely eliminate the branch profits tax that the Code imposes such corporation.

Neither country's tax may be imposed on corporations resident the other country at a rate exceeding 5 percent. Moreover, the S. tax may be imposed only on that portion of the business prof- of the French corporation attributable to its U.S. permanent es- ›lishment which represents the "dividend equivalent amount" of ›se profits in accordance with the Code. (Currently that term is fined in Code section 884(b), under which the dividend equivalent ıount of business profits attributable to a permanent establish- ›nt would generally be the earnings and profits attributable to a S. permanent establishment, plus an additional amount repre- nting any decreases in the permanent establishment's "U.S. net uity" and minus an amount representing any increase in the rmanent establishment's U.S. net equity.) None of the restric- ›ns on the operation of U.S. or French internal law branch tax ovisions apply, however, unless the corporation seeking treaty otection meets the conditions of the treaty's limitation on bene- s article (Article 24A) as it would be amended by the proposed otocol. As described in the discussion of Article XIII below, the nitation on benefits requirements of the proposed protocol are ry similar to, but not identical with, the analogous provisions of e branch profits tax provisions of the Code described above.

Similarly, the protocol would allow France to impose its branch ofits tax only on that portion of the business profits of a U.S. cor- ration attributable to its French permanent establishment and nich is included in the base of the French withholding tax in ac- rdance with the provisions of French internal law.

Where a French or U.S. corporation conducts a trade or business the other country as a member of a partnership, the proposed otocol allows the imposition of the other country's branch profits x on the portion of the business profits attributable to that trade business, apparently only if and to the extent that the trade or ısiness carried on through a permanent establishment.

Other taxes

Consistent with the business profits article of the treaty and the anch profits tax provisions of the proposed protocol, the existing eaty exempts French corporations from the U.S. accumulated ırnings tax (Code secs. 531-537) in any taxable year unless the cor-

poration is engaged in trade or business in the United Sta through a permanent establishment at any time during such ye However, the proposed protocol expands this exemption so that applies to any French corporation that meets the 50 percent own ship test of the limitation on benefits article of the treaty as would be amended by the proposed protocol, regardless of wheth the corporation has a U.S. permanent establishment. Under the isting treaty as it operated prior to the advent of the U.S. bran profits tax, a French corporation with a U.S. permanent establis ment had the choice of risking U.S. accumulated earnings tax accumulations of earnings beyond the reasonable business needs the permanent establishment, or avoiding additional U.S. taxes those earnings either by investing the accumulations in the U business or remitting permanent establishment earnings to t head office at no U.S. tax cost. Under the 1986 Act as it would erate in conjunction with the proposed protocol, the U.S. tax-mi mizing choices would be narrowed: as before, one choice is to re vest the earnings in the business of the U.S. permanent establis ment with no added tax on those earnings; the other choices either investing the earnings in other assets in the United Stat or remitting the earnings to the head office—entail a relatively c tain branch profits tax liability.

Prior to the 1986 Act, the Code imposed a withholding tax on portion of dividends paid by foreign corporations to foreign sha holders if the U.S. effectively connected gross income of the cor ration exceeded a 50 percent threshold over a 3-year period (form sec. 861(a)(2)(B)). The existing treaty limited the imposition of th tax on French corporations so that meeting the threshold requir the existence of a U.S. permanent establishment and satisfying 80-percent test rather than a 50-percent test. The 1986 Act proh ited imposition of this tax on corporations not exempt from t branch profits tax. Consistent with this 1986 Act amendment, wi the limitation under the proposed protocol of the U.S. branch pr its tax on French corporations to cover only their profits attribu ble to U.S. permanent establishments, with the elimination und the proposed protocol of U.S. sourcing for dividends paid by Fren corporations, and with the exemption under the existing trea from U.S. withholding tax on dividends paid by French corpor tions *without* permanent establishments in the United States, t proposed protocol would delete the treaty's limitation on U.S. wit holding from dividends paid by French corporations. (See the d cussion of Article IV above.)

Article IX. Relief from Double Taxation

The proposed protocol adds a new exemption from Fren income tax for certain types of U.S.-related investment income French residents who are U.S. citizens. The proposed protoc would require France to provide this exemption only upon ad quate demonstration by the person claiming the exemption that h or she has complied with his or her U.S. tax obligations. The prot col would also make this demonstration requirement a conditio for obtaining the benefit of the existing treaty exemption fro French tax for French residents who are U.S. citizens and who vis the United States for purposes of study, training, research, teac

, or gaining technical, professional, or business experience. Fily, the proposed protocol would require France to give a tax dit to its residents for U.S. branch profits taxes paid to the ited States in accordance with Article 13 of the treaty as revised the proposed protocol. (See discussion of Article VIII above.)

'he proposed new exemption for U.S. citizens resident in France ers certain U.S. source dividends, interest, and royalties, capital ns from the sale or exchange of capital assets generating such ›mpt income, and profits and gains derived from transactions on ›ublic U.S. options or futures market (for example, the Chicago ard Options Exchange or the Chicago Mercantile Exchange). In ler to qualify for the exemption from French tax, dividends, inest, and royalties must be beneficially owned by the U.S. citizen o is a French resident, and must be derived from sources within United States as that term is defined in the treaty as amended the proposed protocol. In addition, the payor of such dividends, erest, or royalties must meet one of the following four descripns:

\) The United States or any political subdivision or authority ›reof;

3) A U.S. legal entity (for example, a corporation or partnership) principal class of shares or interests in which are substantially d regularly traded on a recognized stock exchange as defined in limitation on benefits article (see discussion of article XI ow);

C) A U.S. corporation the outstanding shares of the voting stock which was not 10 percent or more owned by the French resident ther directly or indirectly) at all times during the period beginng on the first day of the corporation's taxable year preceding year in which the income was paid to its owner and ending on day before the date that payment was made, provided also that percent or more of such stock of the U.S. corporation was not ned by French residents during the same period;

D) A U.S. resident not more than 25 percent of the gross income which for the prior taxable year (if any) consisted directly or inectly of income derived from sources outside the United States.

Capital gains beneficially owned by French residents who are S. citizens from the sale or exchange of capital assets generating S. source income of the kind described above are similarly empt from French tax. However, these gains will be taken into count for other French tax purposes, namely, the determination the threshold of taxation (affecting, for example, marginal tax tes at which gains are taxed) applicable in France to capital ins on movable property.

Under the existing treaty, France exempts its residents who are .S. citizens and who visit the United States for purposes of study, aining, research, teaching, or gaining technical, professional, or isiness experience from tax on certain income from certain serves performed in the United States (Articles 17 and 18 of the eaty). The income exempted from French tax is income that ould be exempt from U.S. tax if earned by a French resident who not a U.S. citizen, but is subject to U.S. tax when earned by a .S. citizen. In order to ensure that this exemption and the new emption described above serve to prevent double taxation, rather

than all taxation, the proposed protocol conditions the availabili of each exemption upon a demonstration by the U.S. citizen clai ing the exemption that he or she has complied with his or her U. income tax obligations, and upon either receipt by the French Mi ister of Economy and Finance or his delegate of such certificati as he may prescribe, or a request to the Minister for refund taxes withheld together with the presentation of any required ce tification.

Article X. Nondiscrimination

The proposed protocol amends the nondiscrimination article the existing treaty (Article 24) to clarify that that article shall n be construed as preventing the application by the United States its branch profits tax or the application by France of its withhol ing tax, as described above in the discussion of Article VIII of t proposed protocol.

Article XI. Limitation on Benefits

The proposed protocol replaces the article of the existing trea which is intended to limit the benefits of the treaty to persons w are entitled to those benefits by reason of their residence in t United States or France with a new limitation on benefits artic modifying existing conditions to eligibility for treaty benefits a containing additional conditions. Unlike the existing article, the a ticle contained in the proposed protocol expressly states that it a plies only in cases where the treaty country resident seeking t benefit of the treaty derives income from the country of which th person is not a resident. The principal condition added in the pr posed limitation on benefits article is the "base erosion" rule. T base erosion rule in the proposed protocol is similar to provisio in the U.S. model treaty, and its language is very similar to t branch profits provisions of the Code and the 1986 protocol to t U.S. income tax treaty with China. In addition, the proposed prot col (unlike the existing treaty) conditions eligibility for relief fro double taxation upon the satisfaction of the requirements of t limitation on benefits article.

The treaty is intended to limit double taxation caused by t interaction of the tax systems of the United States and France they apply to residents of the two countries. At times, howev residents of third countries attempt to use a treaty. Such use known as "treaty shopping," and refers to the situation where person who is not a resident of either country seeks certain ben fits under the income tax treaty between the two countries. Und certain circumstances, and without appropriate safeguards, t nonresident is able indirectly to secure these benefits by establis ing a corporation (or other entity) in one of the countries which, a resident of that country, is entitled to the benefits of the treat Additionally, it may be possible for the third country resident reduce the income base of the treaty country resident by havi the latter pay out interest, royalties, or other amounts under fav able conditions (i.e., it may be possible to reduce or eliminate tax of the resident company by distributing its earnings through d ductible payments or by avoiding withholding taxes on the distrib tions) either through relaxed tax provisions in the resident count

ɔy passing the funds through other treaty countries (essentially, tinuing to treaty shop), until the funds can be repatriated under orable terms.

Limitation on benefits under the existing treaty

'he existing treaty provides that a person other than an individ- (such as a corporation, partnership or trust) is not entitled to benefits of the treaty unless it satisfies any one of an owner- p test, a public company test, or a good business purpose test. der the ownership test, more than 50 percent of the beneficial erest in the person (in the case of a company, more than 50 per- t of the number of shares of each class of shares) must be owned ectly or indirectly by any combination of one or more individual idents of France or the United States, citizens of the United tes, publicly traded companies, or the governments of the ited States or France (collectively, qualifying persons). For ex- ple, this provision denies the benefits of the reduced U.S. with- ding tax rates on dividends or royalties paid to a French compa- that is controlled by individual residents of a third country. is rule is not as strict as that contained in the U.S. model, which uires 75 percent ownership, by residents of the person's country esidence, to preserve benefits.

Jnder the public company test, a company that is a resident of of the countries and that has substantial and regular trading its principal class of stock on a recognized stock exchange in the ited States or France is entitled to the benefits of the treaty re- dless of where its actual owners reside. In addition, any interest it such a company holds is a qualifying interest under the 50- cent ownership test above. The term "recognized securities ex- ange" means any stock exchange registered with the Securities l Exchange Commission as a national securities exchange for rposes of the Securities Exchange Act of 1934, the NASDAQ tem owned by the National Association of Securities Dealers, ., the French stock exchanges (Bourses de Valeurs) and any ıer stock exchange agreed upon by the competent authorities of two countries.

Jnder the good business purpose test, denial of treaty benefits s not occur if the establishment, acquisition, and maintenance an entity that is a resident of the United States or France and conduct of its operations did not have as one of its principal rposes the purpose of obtaining benefits under the treaty. Ac- dingly, the provision does not apply if it is shown that there was treaty shopping motive for forming the company and if its oper- on did not have as one of its principal purposes the purpose of aining the treaty benefits. Thus, the burden of overcoming the aty shopping rule, as under U.S. tax law generally, is on the tax- yer claiming treaty benefits. The Technical Explanation to the posed protocol provides two examples of situations in which it is ended that this rule applies. The first example is a French com- ny not meeting the ownership or public company tests, but that engaged in an active manufacturing business in France. Accord- to the Technical Explanation, U.S. source dividends received m a U.S. subsidiary of the French corporation which are attrib- ıble to income realized by the subsidiary from sales of products

manufactured by the French corporation would be eligible for the percent rate on direct investment dividends provided by the tre ty's dividend article. The second example is a French company n meeting the ownership or public company tests but which (1) hol stocks and securities the income from which is not predominant from U.S. sources, (2) has widely dispersed ownership, and (3) en ploys in France a substantial staff actively engaged in trades stocks and securities owned by the company. The Technical Expl nation states that U.S. source investment income earned by t company would be eligible for a reduced rate of U.S. withholdi tax under the treaty, but not if all three of the above factors we absent.

The proposed protocol

The proposed protocol replaces the 50-percent ownership test d scribed above with a two part test, incorporating both the existi 50-percent ownership test with one modification, and a so-call "base erosion" test. Under the proposed protocol, a person (oth than an individual) which is a resident of one country and deriv income from the other country is not entitled to either the benefi of the treaty or relief from double taxation in its country of re dence (assuming that person meets neither the public company te or the good business purpose test) unless that resident meets t modified 50-percent ownership test *and* not more than 50 perce of the gross income of the person is used directly or indirectly meet liabilities (including liabilities for interest or royalties) to pe sons who are not residents of France or the United States, citize of the United States, the governments of France or the Unite States or local authorities thereof, or political subdivisions of t United States. This latter rule is commonly referred to as t "base erosion" rule and is necessary to prevent a corporation, f example, from distributing (including paying, in the form of d ductible items such as interest, royalties, service fees, or oth amounts) most of its income to persons not entitled to benefi under the treaty. This provision is substantially similar to that i the U.S. model treaty.

As mentioned above, the 50-percent ownership test of the exis ing treaty is modified in the proposed protocol. Under the latte qualifying persons include local authorities of France and t United States, and political subdivisions of the United States, well as the classes of qualifying persons specified in the existi treaty: individual residents of France and the United States, ci zens of the United States, publicly traded companies, and the go ernments of France and the United States.

It appears that any corporation that would satisfy the limitatio on benefits article of the proposed treaty would generally also me the definition of "qualified resident" for branch profits tax pu poses in the Code.[4] That would not have been the case had the pr tocol not introduced the base erosion rule. However, some semant differences remain. For example, a French corporation qualifies f treaty benefits under the protocol if there is substantial and reg

[4] Certain differences between the two tests are eliminated under the pending bill to make te nical corrections to the 1986 Act.

trading of its principal class of stock on a recognized stock ex-
ange, while that corporation would not meet the 1986 Act's
lic company test unless such company's stock were *primarily*
ded on an established securities market (or the corporation were
olly owned by another corporation whose stock were primarily
traded). It may be that, for practical purposes, those tests could
interpreted in substantially the same fashion. Also, although it
unlikely, a French corporation that met the good business pur-
e test might conceivably fail whatever tests the Secretary pro-
lgated under Code section 884(e)(4)(C).

Also as mentioned above, the limitation on benefits article in the
posed protocol, unlike the limitation on benefits article in the
sting treaty, provides that failure to meet the ownership test or
base erosion test will mean that a treaty country resident
her than an individual) would not be entitled to relief from
uble taxation in the residence country. According to the Techni-
Explanation, this provision affects the eligibility of French resi-
nts (other than individuals) for relief from double taxation grant-
by France, but it has no practical effect on relief from double
ation granted by the United States. Under the existing treaty,
United States generally avoids double taxation of business and
estment income of its residents through the foreign tax credit
chanism of the Code. Furthermore, Article 22 of the treaty
hich is not amended by the proposed protocol) provides that the
visions of the treaty shall not be construed to restrict in any
nner any exclusion, exemption, deduction, credit, or other allow-
ce now or hereafter accorded by the laws of one of the parties in
determination of its tax. Thus residents of the United States
entitled to foreign tax credits for certain French taxes regard-
s of the treaty as modified by the proposed protocol.

French residents, on the other hand, are generally not entitled to
ief from double taxation under French internal law unless the
ht to that relief is contained in a treaty. Consequently, under
proposed protocol, French residents (other than individuals)
at meet neither the ownership/base erosion test, the public com-
ny test, nor the good business purpose test and that derive
come from the United States will not be eligible for foreign tax
edits against, or exemptions from French taxes on that income.

Finally, the limitation on benefits article of the proposed protocol
like that of the existing treaty) states expressly that it applies
ly to a person that derives income from the other contracting
te.

ticle XII. Provisions for Implementation

The proposed protocol would add a new Article 25A to the existing
eaty authorizing the competent authorities of the United States
d France to prescribe rules and procedures, jointly or separately,
determine the mode of application of the treaty provisions.

The Secretary of the Treasury, the competent authority of the
ited States, already possesses administrative authority to imple-
ent the treaty through regulation, revenue rulings, revenue pro-
dures, and other publications. The Technical Explanation states
at the purpose of the new Article is to permit explicitly the de-

velopment of certification procedures for determining eligibility treaty benefits, not to modify the substance of those benefits.

As described above, Article IX of the proposed protocol, w provides new exemptions from certain French taxes for cer U.S. source investment income and related gains earned by citizens resident in France, conditions the exemption on bot demonstration by the income recipient that he or she has comp with U.S. income tax obligations, and either (1) receipt by French Minister of Economy and Finance or his delegate of s certification as he may prescribe, or (2) the making of a reques the Minister for a refund of withheld taxes, accompanied by s certification as may be required. Thus, new Article 25A of treaty provides the Minister with express authority to presc (alone or jointly with the U.S. Treasury) procedures for, and the quired content of, the certification called for under Article I the proposed protocol. In addition, new Article 25A provides thority more broadly to develop certification procedures to de mine, for example, that a taxpayer claiming a reduction or el nation of tax liability pursuant to the treaty on income deri from a treaty country is a resident of the other country, that taxpayer meets the requirements of the limitation on benefits a cle, that a tax for which a credit is claimed pursuant to the re from double taxation article has actually been paid, or that other predicate to the entitlement to a treaty benefit is met.

Article XIII. Entry into Force

The proposed protocol will enter into force upon the date of ceipt by each party of notification from the other that the const tional procedures necessary for the proposed protocol to enter i force have been satisfied. In case notifications are received on ferent dates, the date of receipt of the last such notification wil the date of entry into force. Once in force, the provisions of the tocol relating to taxes withheld at source will apply to amou payable on the first day of the second month following the dat entry into force. The provisions relating to the U.S. branch pro tax and French withholding tax on profits will apply to profits r ized in taxable years ending on or after the date of entry into fo The provisions regarding the exemption from French tax for c tain U.S. source investment income and related gains earned U.S. citizens resident in France will apply retroactively to inco described in those provisions derived on or after January 1, 19 The remaining provisions of the proposed protocol will apply taxable years beginning on or after the date of entry into force.

Article XIV. Termination

The proposed protocol will remain in force as long as the U French income tax treaty remains in force. The present treaty m be terminated by either country giving notice of termination to other through diplomatic channels at least six months before end of any calendar year.

Exchange of Notes

ontemporaneously with the signing of the proposed protocol on e 16, 1988, France and the United States exchanged notes to ify that nothing in the source rule paragraph of the interest ar- of the treaty, as it would be amended by the proposed proto- shall be understood to prevent or limit the application by a tracting state of its internal law, or its treaty with a third state, respect to interest paid by a permanent establishment located he contracting state to any resident of a third state. The inter- laws referred to in the notes are (1) in the case of the United tes, those Internal Revenue Code provisions that impose tax on rest paid by a foreign corporation's trade or business in the ted States, as described in Code section 884(f)(1)(A), and (2) in case of France, articles 119 bis and 125A of the Code General Impots. The notes clarify, for example, that the United States impose its 30 percent withholding tax on interest paid by a . branch of a French corporation to a resident of a third coun- assuming that the interest does not qualify for an exemption er the Code or an exemption or rate reduction in a treaty that third country has with the United States.

O